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IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

ITHACA INDUSTRIES, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

1. Whether the United States Court of Appeals for the Fourth Circuit erred in holding, contrary to *Newark Morning Ledger Co. v. United States,* —— U.S. ——, 113 S. Ct. 1670 (1993), that an acquired intangible asset cannot be amortized because it has no limited life as a matter of law?

2. Whether the United States Court of Appeals for the Fourth Circuit erred in holding, contrary to *Citizens & Southern Corp. v. Commissioner,* 919 F.2d 1492 (11th Cir. 1990), *affirming* 91 T.C. 463 (1988), that as a matter of law the life of an acquired intangible asset cannot be established by the statistical methodology of projecting future decay from historical experience?

3. Whether the United States Court of Appeals for the Fourth Circuit erred, contrary to *Icicle Seafoods, Inc. v. Worthington,* 475 U.S. 709, 106 S. Ct. 1527 (1986), in making an ultimate finding of fact?

PARTIES TO THE PROCEEDING

All parties appear in the caption. There are no parent companies or nonwholly owned subsidiaries.

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	iv
OFFICIAL AND UNOFFICIAL REPORTS	1
STATEMENT OF GROUNDS ON WHICH THE JURISDICTION OF THIS COURT IS INVOKED	1
STATUTES AND REGULATIONS INVOLVED	2
STATEMENT OF THE CASE	2
BASIS FOR FEDERAL JURISDICTION IN THE COURT OF FIRST INSTANCE	5
ARGUMENT	5
I. THE COURT OF APPEALS ERRED IN HOLDING, CONTRARY TO *NEWARK MORNING LEDGER*, THAT AN ACQUIRED INTANGIBLE ASSET CANNOT BE AMORTIZED BECAUSE IT HAS NO LIMITED LIFE AS A MATTER OF LAW	5
II. THE COURT OF APPEALS ERRED IN HOLDING, CONTRARY TO *CITIZENS & SOUTHERN CORP. v. COMMISSIONER*, 919 F.2d 1492 (11th Cir. 1990), *AFFIRMING* 91 T.C. 463 (1988), THAT AS A MATTER OF LAW THE LIFE OF AN INTANGIBLE ASSET CANNOT BE DETERMINED BY THE STATISTICAL METHODOLOGY OF PROJECTING FUTURE RATE OF DECAY FROM HISTORICAL EXPERIENCE	11
III. THE COURT OF APPEALS ERRED, CONTRARY TO *ICICLE SEAFOODS, INC. v. WORTHINGTON*, 475 U.S. 709, 106 S. CT. 1527 (1986), IN MAKING AN ULTIMATE FINDING OF FACT	13
CONCLUSION	16

TABLE OF AUTHORITIES

Cases — Page

Citizens & Southern Corp. v. Commissioner, 919 F.2d 1492 (11th Cir. 1990), *affirming* 91 T.C. 463 (1988) ..... *passim*

Citizens & Southern Corp. v. Commissioner, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990) 3, 11-12

Donrey, Inc. v. United States, 809 F.2d 534 (8th Cir. 1987) 6

Icicle Seafoods, Inc. v. Worthington, 475 U.S. 709, 106 S. Ct. 1527 (1986) 13-15

INDOPCO, Inc. v. Commissioner, 503 U.S. ——, 112 S. Ct. 1039 (1992) 7

Massey Motors, Inc. v. United States, 364 U.S. 92, 80 S. Ct. 1411 (1960) 7

Newark Morning Ledger Co. v. United States, —— U.S. ——, 113 S. Ct. 1670 (1993) ..... *passim*

Newark Morning Ledger Co. v. United States, 734 F. Supp. 176 (D.N.J. 1990), *rev'd*, 945 F.2d 555 (3d Cir. 1991), *rev'd*, —— U.S. ——, 113 S. Ct. 1670 (1993) 5

Newark Morning Ledger Co. v. United States, 945 F.2d 555 (3d Cir. 1991), *rev'd*, —— U.S. ——, 113 S. Ct. 1670 (1993) 5

Statutes, Regulation and Rules

26 U.S.C. § 167 (1986) 2

28 U.S.C. § 1254(1) 1

Treas. Reg. § 1.167(a)(3) 2

Sup. Ct. R. 10(a) 13

Sup. Ct. R. 16 17

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PETITION FOR A WRIT OF CERTIORARI

OFFICIAL AND UNOFFICIAL REPORTS

The opinion of the United States Tax Court (App. p. 14a) is reported at 97 T.C. 253 (1991). The opinion of the United States Court of Appeals for the Fourth Circuit (App. p. 1a) is reported at 17 F.3d 684 (1994).

STATEMENT OF GROUNDS ON WHICH THE JURISDICTION OF THIS COURT IS INVOKED

1. The judgment of the United States Court of Appeals was entered on February 23, 1994.

2. On March 22, 1994, a Petition for Rehearing with Suggestion for Rehearing in Banc was denied.

3. The jurisdiction of this Court to review the judgment on Petition for Certiorari rests on Section 1254(1) of the Judicial Code (28 U.S.C. § 1254(1)).

STATUTES AND REGULATIONS INVOLVED

Statutes and regulations involved are Section 167 of the Internal Revenue Code of 1986, 26 U.S.C. § 167 (App. p. 45a) and Treas. Reg. § 1.167(a)(3) (App. p. 45a).

STATEMENT OF THE CASE

The sole issue involved in this case is the propriety of federal income tax deductions by Petitioner Ithaca Industries, Inc. ("Ithaca") for the cost of an acquired intangible asset, an assembled workforce, amortized over its statistically determined useful life. Depreciation of tangible assets is generally permitted under Section 167(a) of the Internal Revenue Code, with little controversy. Depreciation of *intangible* assets, however, has been complicated by the fact that no depreciation is permitted for two intangible assets, goodwill and going concern value, pursuant to Treas. Reg. § 1.167(a)(3).[1] Distinguishing other intangible assets from goodwill and going concern value has been the source of much litigation and confusion in the application of the federal tax laws, of which this case is illustrative.

On September 22, 1983, Ithaca acquired all of the assets of a corporation which manufactured hosiery, undergarments and polo shirts in a "cash-out" merger under Delaware law. In connection with the acquisition, Ithaca had the acquitted assets appraised, including its assembled workforce of 5,153 hourly production workers which the appraisal company valued at $7.7 million and for which it determined a useful life of seven years.

Ithaca took depreciation deductions for the acquired assets, including the assembled workforce, in its fiscal years

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[1] Although the Internal Revenue Code refers only to depreciation, cost recovery of intangible assets is commonly described as amortization. See *Newark Morning Ledger Co. v. United States*, —— U.S. ——, 113 S. Ct. 1670, 1683 n.1 (1993).

ending February, 1984 and February, 1985. The Commissioner of Internal Revenue ("Commissioner") disallowed the deductions and Ithaca petitioned the United States Tax Court in April, 1989. The hearing before the Tax Court lasted four days, two of which were devoted to statistical evidence as to the useful life of the assembled workforce. Ithaca proffered the testimony and report of Dr. Thomas D. Doerfler to determine the useful life of the assembled workforce. Dr. Doerfler, who obtained both his M.S. and Ph.D degrees in statistics, is the principal statistician at Arthur D. Little, Inc., with over twenty-two years of experience as a statistical consultant. Dr. Doerfler was the statistical expert for the prevailing taxpayer in *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990) ("*Citizens & Southern*"), and he used the same methodology in determining the useful life ("lifing") of Ithaca's assembled workforce as he did in lifing Citizens & Southern's acquired core bank deposits. He determined the useful life of the workforce by analyzing the useful lives of the individuals making up that force prior to and on the acquisition date. That study of the workforce's composition over a four year period permitted him to statistically determine that, on average, the assembled workforce, as it existed on the acquisition date, would decay over 6.8 years. His detailed report is 39 pages and concluded that:

> In conclusion, it is my opinion that the analytical methods described herein support the contention that this assembled workforce has a well-defined life and exhibits predictable decay rates, both of which can be estimated in an objective manner that is consistent with sound statistical principles.

The Tax Court did not make a factual finding on the statistical evidence proffered by Ithaca because it determined that the assembled workforce was not amortizable as a matter of law as it was subject to the "mass-asset rule" (despite the fact that the asset was not self-regenerat-

ing) and also because an assembled workforce traditionally resembled going concern value. Ithaca appealed to the United States Court of Appeals for the Fourth Circuit.

After the appeal was filed, but before argument, this Court held in *Newark Morning Ledger Co. v. United States*, —— U.S. ——, 113 S. Ct. 1670 (1993) ("*Newark Morning Ledger*") that an acquired intangible asset can be amortized if the taxpayer proves that the asset has an ascertainable value and a limited useful life, the duration of which can be ascertained with reasonable accuracy, and that such intangible assets are no longer nonamortizable as a matter of law despite any traditional resemblance to goodwill.

The United States Court of Appeals for the Fourth Circuit held that the Tax Court erred in applying the mass-asset rule in this case since the assembled workforce was not self-regenerating. The divided panel affirmed the Tax Court's denial of relief to Ithaca, however, on the ground that neither Ithaca's statistical methodology (which it did not examine) nor *any* statistical methodology could determine a useful life of the assembled workforce, as a matter of law.

The Court of Appeals recognized that going concern value and goodwill are closely related and that this case could not be distinguished from *Newark Morning Ledger* because it involves going concern value. 17 F.3d at 687, App. p. 5a. However, the Court of Appeals attempted to distinguish *Newark Morning Ledger* on the ground that it involved paid subscribers and not an assembled workforce. It attempted to distinguish *Citizens & Southern* on the ground that it involved core bank deposits and not an assembled workforce. Judge Phillips dissented on the ground that the Court of Appeals should not decide as a matter of law that the useful life of Ithaca's workforce could not be determined, and that the case should be remanded to the Tax Court for factual findings as to whether Ithaca's proffered evidence established the useful life of the workforce.

BASIS FOR FEDERAL JURISDICTION IN THE COURT OF FIRST INSTANCE

The United States Tax Court had jurisdiction of this matter under Sections 6213, 6214 and 7442 of the Internal Revenue Code of 1986, 26 U.S.C. §§ 6213, 6214 & 7442.

ARGUMENT

The Court of Appeals, by incorrectly limiting the effect of *Newark Morning Ledger* and *Citizens & Southern* to the particular assets involved in those cases, has recreated confusion in this area of law so that lower courts and tax advisors and taxpayers will, absent direction by this Court, be uncertain as to the proper rule to be applied in determining federal income tax deductions for amortization of acquired intangible assets.

I. THE COURT OF APPEALS ERRED IN HOLDING, CONTRARY TO *NEWARK MORNING LEDGER*, THAT AN ACQUIRED INTANGIBLE ASSET CANNOT BE AMORTIZED BECAUSE IT HAS NO LIMITED LIFE AS A MATTER OF LAW.

In *Newark Morning Ledger*, a newspaper claimed a tax deduction for the amortized acquisition cost of the paid subscribers acquired by its predecessor. The Internal Revenue Service ("Service") denied the deduction on the ground that the paid subscribers were an inherent part of goodwill, which is not amortizable. The District Court held that the paid subscribers could be amortized since a value and limited useful life had been established. 734 F. Supp. 176 (D.N.J. 1990). The United States Court of Appeals for the Third Circuit reversed the decision of the District Court. 945 F.2d 555 (3d Cir. 1991). The Service argued on appeal that the District Court had erred as a matter of law in failing to require the newspaper to prove, in addition to a reasonable estimate of useful life and an ascertainable value, that the asset was not otherwise goodwill. The Court of Appeals agreed, and denied

the amortization deduction despite the fact that the asset had a defined useful life and an ascertainable value.

This Court granted certiorari and in its opinion it described the issue as whether the Service "may treat as nondepreciable an intangible asset proved to have an ascertainable value and a limited useful life, the duration of which can be ascertained with reasonable accuracy, solely because the IRS considers the asset to be goodwill as a matter of law." —— U.S. at ——, 113 S. Ct. at 1672. The Court noted a conflict between the Court of Appeals' decision on this issue and the rulings in *Donrey, Inc. v. United States,* 809 F.2d 534 (8th Cir. 1987) and *Citizens & Southern.* The Eighth and Eleventh Circuits had held that an intangible asset is amortizable if a limited life and ascertainable value are established, despite the fact that the asset otherwise resembles or contains elements of what was traditionally regarded as goodwill. This Court adopted the position of the Eighth and Eleventh Circuits. It reversed the Court of Appeals, reasoning that since goodwill is nonamortizable because it has no ascertainable limited life, if such a life can be proved for an asset, it is not and cannot be goodwill and can be amortized. —— U.S. at ——, 113 S. Ct. at 1680. The Court held that if a taxpayer proves an ascertainable value and a limited useful life, the duration of which can be ascertained with reasonable accuracy, it may amortize the asset, and that such acquired intangible assets are no longer nonamortizable as a matter of law despite any traditional resemblance to goodwill.

Among the assets obtained by Ithaca when it purchased the assets of its predecessor was an assembled workforce of production employees. In order to accurately determine its annual income by offsetting annual revenues against expenses relating thereto, Ithaca engaged experts to determine the useful life of the asset and its value and began to amortize that value over such useful life.[2]

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[2] Matching of income with expenses of generating it, including depreciation, prevents distortion in calculating income for tax pur-

Ithaca retained Dr. Doerfler, the same statistician who performed the lifing study in *Citizens & Southern*. He determined the useful life of the assembled workforce using the same methodology he used in *Citizens & Southern* —he analyzed the useful lives of the individuals making up the workforce prior to and on the acquisition date over a four year period. The methodology used by Dr. Doerfler to establish the useful life of the asset was also identical to that employed by the taxpayer in *Newark Morning Ledger*. His study permitted him to statistically determine that, on average, the assembled workforce as it existed on the acquisition date would decay over 6.8 years.

The Tax Court did not make a factual finding on the statistical evidence proffered by Ithaca because it determined that the assembled workforce was not amortizable as a matter of law as it was subject to the "mass-asset rule" and also because it traditionally resembled going concern value. On appeal, the Court of Appeals correctly concluded that the mass-asset rule does not apply to bar amortization to Ithaca, since the workforce was not self-regenerating. Rather than reverse and remand the case for a determination by the Tax Court of the facts in this case, however, the court determined as a matter of law that the workforce could not be amortized, stating:

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poses. See *Newark Morning Ledger Co. v. United States*, —— U.S. ——, 113 S. Ct. 1670, 1680 (1993), citing *INDOPCO, Inc. v. Commissioner*, 503 U.S. ——, 112 S. Ct. 1039, 1043 (1992). See also *Massey Motors, Inc. v. United States*, 364 U.S. 92, 104, 80 S. Ct. 1411, 1418 (1960): "[I]t is the primary purpose of depreciation accounting to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use (excluding maintenance expense) of the asset to the periods to which it contributes." Thus the immediate income generated by an acquired workforce in place must be offset by the cost of acquiring it. One could avoid this cost by assembling a workforce from scratch, but the attendant income would be avoided as well. Similar immediate income is generated by an acquired base of newspaper paid subscribers or an acquired base of bank depositors.

> Because the Tax Court did not feel that a regenerating asset such as a workforce could waste, it did not undertake to assess Ithaca's statistical evidence on these questions in any detail. *We need not pay detailed attention to Ithaca's statistical methodology, either,* but we look beyond this evidence for a different reason. We do not doubt that Ithaca's workforce, as constituted on the day of the merger, began to decline in size and value with the first resignation, termination, or death in the workforce, and that it continued to decline due to these and other factors. Nor do we take issue at this time with the value Ithaca placed on that workforce. *The difficulty in our view is that under these circumstances there can be no defensible estimation of the duration of any one person's employment, nor of the useful life of the workforce of which he or she is a part.*

17 F.3d at 689, App. pp. 8a-9a. (emphasis added).

As in *Citizens & Southern,* Ithaca performed a follow-up study subsequent to the acquisition to test its projections, which study corroborated the predictions. In contrast to the endorsing effect of such corroboration recognized in *Citizens & Southern,* the Court of Appeals below found this to be "happenstance". 17 F.3d at 690, App. p. 11a. The Court of Appeals went on to hold that *no* statistical approach to a workforce such as Ithaca's would permit a useful life to be determined. 17 F.3d at 690, App. p. 11a.

The holding of the Court of Appeals that the assembled workforce cannot be amortized as a matter of law represents the state of the law in some circuits prior to the decision in *Newark Morning Ledger* and the rule rejected by that decision.

The Court of Appeals did give lip service to *Newark Morning Ledger,* attempting to distinguish it by stating:

> An employee is not a subscription; indeed, a workforce consisting of human beings perhaps could be no better described than as "composed of constantly

> fluctuating components." We note in this regard that the record discloses no predetermined limits of any sort, contractual or otherwise, upon the relationship between Ithaca and its employees. This means that in contrast to a subscription, which is susceptible mainly to the influences affecting one actor, the subscriber, a single employment relationship is susceptible to changing influences affecting two actors, the employer and the employee.

17 F.3d at 690, App. p. 10a.

The Court of Appeals' attempt to distinguish *Newark Morning Ledger* is not convincing. First, it was not "subscriptions" that were amortized in *Newark Morning Ledger,* but paid subscribers, who are human beings just as are Ithaca's workers. There is no evidence in the record that the workforce in place on October 28, 1983 --the workforce being amortized—was "constantly fluctuating". And while there were no predetermined limits or contracts between Ithaca and its employees, the paid subscribers amortized in *Newark Morning Ledger* consisted of at-will subscribers, also without contracts. Finally, the paid subscribers were also affected by two actors as, for instance, in the case of subscribers canceled by the newspaper for failure to pay.

The fact that paid subscribers and an assembled workforce are subject to different influences does not mean that a determinable life cannot be established for the workforce. All assets are affected by different influences and the influences upon those two assets are taken into account in the application of the statistical methodology of determining the useful life of the asset. No matter how many "actors" affect the asset, their influence is reflected in the historical life of the asset which permits a reasonable projection of future decay rate.

The distinctions raised by the Court of Appeals are distinctions without a difference. Made without any "detailed attention to Ithaca's statistical methodology", it

is clear that the Court of Appeals simply does not agree with the rule established in *Newark Morning Ledger* and will, at most, restrict its rule to an asset of the same type and size there involved. The Court of Appeals revealed its disagreement with *Newark Morning Ledger* not only by the effect of its opinion but by its language, as indicated by its statement: "Without intimating a view whether Newark Morning News' [*sic*] method would produce an *adequate* estimate, we can say that this case presents a rather different set of circumstances." 17 F.3d at 690, App. p. 10a.

There is no hint in *Newark Morning Ledger* that the Court felt that the efficacy of the methodology it approved might vary with the nature of the asset being amortized or that the rule it pronounced could be ignored if the asset in question were other than paid subscribers.

By not permitting Ithaca to establish in the trial court that the duration of the useful life of its assembled workforce can be ascertained with reasonable accuracy, the Court of Appeals denied Ithaca its ability to even *attempt* to meet the test established by the Court in *Newark Morning Ledger*. Implicit in that test is the opportunity to meet the standard, which was not granted here. The decision of the Court of Appeals simply cannot be reconciled with that of the Court in *Newark Morning Ledger*. This creates such a conflict on an important matter of federal law that justifies this Court's direction.

There are pending in the lower courts and before the Internal Revenue Service numerous cases dealing with the issue of amortization of acquired intangible assets, including an acquired workforce. The lower courts need guidance and direction as to what rule should be applied. It was thought that the matter was put to rest by *Newark Morning Ledger*. However, if its effect can be limited to the asset there involved, the nationwide administration of the federal tax laws and the inconsistency of decisions of the lower courts in this area will be as confusing as prior to *Newark Morning Ledger*.

II. THE COURT OF APPEALS ERRED IN HOLDING, CONTRARY TO *CITIZENS & SOUTHERN CORP. v. COMMISSIONER*, 919 F.2d 1492 (11th Cir. 1990), *AFFIRMING* 91 T.C. 463 (1988), THAT AS A MATTER OF LAW THE LIFE OF AN INTANGIBLE ASSET CANNOT BE DETERMINED BY THE STATISTICAL METHODOLOGY OF PROJECTING FUTURE RATE OF DECAY FROM HISTORICAL EXPERIENCE.

In *Citizens & Southern,* Citizens & Southern Corp., a national bank ("Bank"), acquired nine banks. It allocated the purchase price of each bank among its tangible and intangible assets, with the residual amounts being allocated to goodwill and going concern value. Among the intangible assets to which a portion of the purchase price was allocated were "core deposits". Such deposits are valuable to a bank because they do not pay market rates of interest and are a low-cost source of funds. 91 T.C. at 465. These accounts do not stay open indefinitely but close for such reasons as marriage, divorce, relocation, death or dissatisfaction with the services offered by the bank. 91 T.C. at 466. The Bank developed a methodology to value the core deposits and by studying the history of such deposits over a period, also established a useful life for them. It depreciated the value of the core deposits over that useful life for federal income tax purposes. The Service denied the deductions and the Bank petitioned the Tax Court for review. During trial, the Commissioner argued that the core deposits were not depreciable because they were inherently a part of goodwill, and therefore not depreciable as a matter of law. At trial, the Bank proffered expert testimony and other evidence to establish the value of the core deposits.

The Bank's evidence on useful life included "lifing studies" of deposits for periods ranging from three months to thirteen months immediately prior to the acquisition dates to determine their longevity from actual experience. 91 T.C. at 500. The Bank engaged Dr. Thomas Doerfler, who had performed numerous lifing studies, to conduct

an independent lifing study and to estimate the lives of the core deposits. He took into account historical data up to the time of the acquisitions and used an analytical method based upon probability theory to estimate the remaining life of the acquired core deposits. His report concluded:

> "In conclusion, it is my opinion that the analytical methods described here support the contention that these deposit bases have a well-defined life, and exhibit predictable decay rates, both of which can be estimated in an objective manner that is consistent with sound statistical practices."

91 T.C. at 501. The Bank did a follow-up study to test the projections against actual results and found the projections corroborated by the actual closures. 91 T.C. at 502. The Tax Court concluded that the Bank had shown that the core deposits had a limited useful life, the duration of which the Bank ascertained with reasonable accuracy. 91 T.C. at 505. This holding was affirmed *per curiam* by the United States Court of Appeals for the Eleventh Circuit, 919 F.2d 1492 (11th Cir. 1990).

The Court of Appeals in the case at bar attempted to distinguish the ability to amortize a workforce from the ability to amortize a bank's deposit base, permitted in *Citizens & Southern*. It noted that a workforce is subject to different influences than those that affect a deposit base. But as stated above with regard to paid subscribers, all assets are affected by different influences. Those influences are taken into account in the application of the statistical methodology of determining the useful life of a particular asset; *i.e.*, after an asset is studied over time (with all influences affecting that asset being reflected in the data) the useful life of that particular asset can be statistically determined. The fact that an asset is affected by influences different from those that affect another asset does not mean that the life of the former asset cannot

be statistically determined. It simply means that its useful life will be different than that of the latter asset. The core deposits in *Citizens & Southern,* for example, are affected by different influences, and have a different useful life, than the paid subscribers in *Newark Morning Ledger.* Yet application of the same statistical methodology used by Dr. Doerfler was approved in both instances. The Court of Appeals erred in concluding that the life of the assembled workforce cannot be statistically determined because it is affected by influences that do not affect other assets.

The Court of Appeals attempted to avoid the rule in *Citizens & Southern* on the ostensible ground that the identity of the asset being analyzed was different and that it was subject to different influences. In reality, the rule was avoided simply because the Court of Appeals did not agree with that rule—that an acquired intangible asset can be amortized.

Thus, there is a conflict between the rule in *Citizens & Southern*—that a lifing methodology that uses historical results to project future rates of decay can establish the useful life of an acquired intangible asset—and the decision of the Court of Appeals that such a methodology cannot as a matter of law do so here. This creates such a conflict involving application of important federal law that justifies this Court's direction.

III. THE COURT OF APPEALS ERRED, CONTRARY TO *ICICLE SEAFOODS, INC. v. WORTHINGTON,* 475 U.S. 709, 106 S. CT. 1527 (1986), IN MAKING AN ULTIMATE FINDING OF FACT.

Rule 10(a) of this Court's rules provides that the Court will consider exercising its discretion in granting certiorari when a United States court of appeals has so far departed from the accepted and usual course of judicial proceedings as to call for an exercise of the Court's power of supervision.

In *Icicle Seafoods, Inc. v. Worthington,* 475 U.S. 709, 106 S. Ct. 1527 (1986) the Court of Appeals for the Ninth Circuit made factual findings. The Court granted certiorari and reversed, holding that factual findings are the province of the trial court and courts of appeals should not make factual findings on their own. Ithaca's expert statistician, with 22 years of experience, filed a detailed report 39 pages long. A portion of the uncontradicted testimony on the issue of a determinable life was as follows:

> Q. Dr. Doerfler, in your opinion, did the Ithaca workforce in place on October 28, 1983, have a limited remaining life?
>
> A. Yes. And that is demonstrated in the exhibit that we just looked at.
>
> Q. In your opinion, could that limited remaining life be estimated with reasonable accuracy based on information available on October 28, 1983?
>
> A. Yes. As a result of fitting and using these probability—or—this probability law or these probability laws, one can estimate the expected remaining life.
>
> Q. Does your report, Exhibit 6 with the appendix 6-A, accurately reflect your opinions as to the expected remaining life of the work force at Ithaca—
>
> A. Yes.
>
> Q. —as of October 28, 1983?
>
> A. Yes.
>
> Q. Was your lifing analysis, in your opinion, competent, objective and sound?
>
> A. Yes.
>
> Q. Does your lifing analysis derive reasonable and sound estimates of decay?
>
> A. Yes.

The statistical validity of Ithaca's methodology in lifing the asset is a factual, not a legal, issue. If there were indeed a *statistical* problem with Ithaca's methodology, one would have expected the expert for the Service to present that challenge, but he did not do so. The Serv-

ice's expert did not testify that there were any shortcomings in the statistical methodology employed by Dr. Doerfler; he simply argued that a workforce is part of going concern value and has no ascertainable life for that reason.

The trial court heard two days of testimony, including cross-examination, from both parties as to the statistical methodology employed by Ithaca. The trial court itself asked questions of the experts about the statistical methodology and its efficacy. Yet the Court of Appeals, which concededly did not "pay detailed attention to Ithaca's statistical methodology", held that Ithaca's workforce "was not an amortizable asset because its characteristics suggest no sufficiently accurate means of estimating its useful life." 17 F.3d at 689, 690, App. p. 11a.

The Court of Appeals did not study the statistical evidence proffered by Ithaca and determine that Ithaca failed to meet its burden of proof. Indeed, it concededly paid no "detailed attention to Ithaca's statistical methodology." Rather, it held that as a matter of law neither Ithaca's methodology nor any methodology would suffice to determine the useful life of the assembled workforce. Although its holding seems to be one of law, it is possible to construe the court's opinion as finding as a fact that, statistically, no determinable life can be established.

Judge Phillips in his dissent below opined that the ability of Ithaca's statistical methodology to establish a determinable life should be determined in the first instance by the trial court. Ithaca agrees. The Court of Appeals made a finding as to the validity of Ithaca's statistical methodology without any analysis of that methodology and essentially made an ultimate finding of fact that the life of the workforce cannot statistically be established. Such a finding violates the rule reaffirmed in *Icicle Seafoods, Inc. v. Worthington, supra,* that courts of appeals should not make factual findings on their own. In making such finding, the Court of Appeals has so far departed

from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision. The decision of the Court of Appeals should be vacated with instructions that the case be remanded to the Tax Court for reconsideration in light of *Newark Morning Ledger*.

CONCLUSION

This case involves important questions as to the proper application of federal law, questions that concern many taxpayers nationally in several lower courts, where similar issues are pending. Both taxpayers and the lower courts need guidance and a uniform rule on the issue. Does the rule in *Newark Morning Ledger* in fact apply only to cases involving paid subscribers, as effectively held by the Court of Appeals in the instant case? Surely the Court did not grant certiorari in that case in order to issue so limited a rule.

Should the lower courts follow the rule in *Citizens & Southern* that the useful life of an acquired intangible asset can be established by a lifing methodology that uses historical results to project future rates of decay, or the rule of the Court of Appeals below that it cannot?

Other litigants involved in the cases presently pending in lower courts are vitally interested in the outcome of this Court's resolution of these issues, and a uniform rule on the point is needed.

The Court of Appeals declined "to choose an appropriate useful life convention"—an arbitrary useful life for the workforce. 17 F.3d at 690, App. p. 11a. But no convention is required. The Court in *Newark Morning Ledger* established all the rule that is necessary—that if a taxpayer is able to prove the life of an acquired intangible asset with reasonable accuracy, it can amortize the asset. When the Court of Appeals determined that the characteristics of the workforce suggest no sufficiently accurate means of estimating its useful life, it adopted

the reasoning of the cases rejected by the Court in *Newark Morning Ledger*, that some assets are inherently incapable of having a determinable life and thus are inherently incapable of being amortized. The decision of the Court of Appeals, Ithaca respectfully suggests, is so inconsistent and incongruent with the decision in *Newark Morning Ledger*—and so clearly erroneous—that this case is appropriate for summary disposition on the merits under Rule 16.

For these reasons it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
FOURTH CIRCUIT

No. 92-1045

ITHACA INDUSTRIES, INC.,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Argued Oct. 27, 1993

Decided Feb. 23, 1994

OPINION

MICHAEL, District Judge:

Ithaca Industries, Inc. (Ithaca) appeals from the decision of the Tax Court denying depreciation deductions for Ithaca's assembled workforce and assessing Ithaca for tax deficiencies as a result. Because we believe that the useful life of an assembled workforce such as Ithaca's has no reasonably ascertainable limits, we affirm.

I.

At all relevant times for the purposes of this case, Ithaca was a Delaware corporation with its headquarters in Wilkesboro, North Carolina. The company manufactures hosiery, undergarments, and polo shirts in plants

located in North and South Carolina, Georgia, and Arizona. On September 22, 1983, some 35 years after Ithaca was first founded, a corporation was formed for the purpose of acquiring the assets and business of the company. That corporation, called "New Ithaca Corporation," subsequently offered "Old Ithaca" $110 million in notes and cash in exchange for all of Old Ithaca's common stock. The purpose of the merger was primarily to provide liquidity to George Abbott, the company's retiring founder and majority stockholder.

After the transaction was completed on October 28, 1983, New Ithaca changed its name to Ithaca Industries, Inc., the appellant in this case. There were no negotiations with Old Ithaca prior to this date regarding the allocation of portions of the purchase price to the assets of New Ithaca was to acquire. Prior to the merger, however, New Ithaca obtained an appraisal of Old Ithaca's assets, to be used to determine an allocation of basis for tax purposes. One such asset was Old Ithaca's assembled workforce of 5,153 hourly production workers and 212 staff employees.[1] The appraiser assigned this "workforce in place" a value of $7.7 million, with a useful life of seven years for production employees, and eight years for staff employees.

Based on the appraisal, Ithaca took depreciation deductions in the fiscal years ending February, 1984 and February, 1985. When appellee, Commissioner of the Internal Revenue Service (Commissioner) disallowed the deductions, Ithaca petitioned the Tax Court in April, 1989. The Tax Court found for the Commissioner on the workforce issue, holding that a workforce is nondepreciable because it is not a "wasting asset." *Ithaca Industries, Inc. v. Comm'r,* 97 T.C. 253, 1991 WL 151392 (1991). This appeal followed.

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[1] Also at issue below were certain raw materials supply contracts upon which Ithaca took depreciation deductions. Respondent did not take exception to the Tax Court's holding regarding the contracts.

The central issue on appeal is whether an assembled workforce is an intangible asset having an ascertainable, limited useful life over which the value of the asset may be amortized. The Commissioner raised a second potential issue for the first time on appeal.[2] The Commissioner suggests that the applicable provisions of the Internal Revenue Code as of Ithaca's merger required it to make a specific election in order to obtain a "stepped-up" basis in the assets it acquired. Absent such an election, appellee submits, the basis in the acquired assets—including the assembled workforce—is a "carryover" basis of zero.[3] Without a basis, there obviously can be no depreciation, and the Commissioner asks us to affirm on those grounds.[4] We decline to pass on the merits of this question, however, principally because its development before us, and before the Tax Court, was incomplete. We therefore will resolve the case by deciding the appropriate tax treatment of an assembled workforce with a stepped-up basis in the surviving corporation's hands.

II.

We begin with the prosaic observation that every asset declines in some manner, and thus, in theory, every asset could be amortized. This observation is set forth more or less in Section 167(a) of the Internal Revenue Code. At the time of Ithaca's merger, that section stated: "There shall be as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear . . . of prop-

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[2] As the Commissioner points out in his brief, respondent is free to rely upon any matter appearing in the record in support of the decision below without filing a cross-appeal. *See Schweiker v. Hogan*, 457 U.S. 569, 585 n. 24, 102 S.Ct. 2597, 2607 n. 24, 73 L.Ed.2d 227 (1982).

[3] The carryover basis would be zero because Old Ithaca's assets were fully depreciated in its hands.

[4] The Commissioner recognizes that his failure to appeal that portion of the Tax Court's decision allowing deductions for the raw materials supply contracts precludes him from making this argument with regard to those particular assets.

erty used in the trade or business, or . . . of property held for the production of income."[5] I.R.C. § 167(a) (1983). Things become a good deal more complicated, however, when we seek in practical terms to quantify "exhaustion" and "wear and tear" for the purpose of assigning depreciation deductions to specific assets. To do so, Congress has often had to resort to conventions.[6]

Courts too have adopted conventions,[7] one of which has been the categorical exclusion of "goodwill" and "going-concern value" from the purview of section 167. *See Houston Chronicle Publishing Co. v. United States,* 481 F.2d 1240 (5th Cir.1973), *cert. denied,* 414 U.S. 1129, 94 S.Ct. 867, 38 L.Ed.2d 754 (1974). "While goodwill and going-concern value are often referred to conjunctively, technically going-concern value is the ability of a business to generate income without interruption, even though there has been a change in ownership; and goodwill is a 'preexisting' business relationship, based on a continuous course of dealing, which may be expected

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[5] The term "property" includes intangibles. *Citizens & Southern Corp. v. Commissioner,* 91 T.C. 463, 1988 WL 90987 (1988), *aff'd,* 900 F.2d 266 (11th Cir.1990).

[6] Section 168 of the Internal Revenue Code sets forth a variety of amortization schedules which assign recovery periods for various categories of depreciable assets. A new section 197 was added to the I.R.C. on August 10, 1993, which assigns a 15-year recovery period for intangible assets enumerated in that section. Had this section existed in 1983, this case would be less difficult in one respect, for section 197(d)(1)(C)(i) includes "workforce in place" as an intangible asset subject to depreciation over 15 years, a period roughly twice as long as the period Ithaca claimed. Of course, the difficulty of assigning an initial value to such a workforce still would remain.

[7] In fact, the Treasury Regulations appear to envision an evolving case law on the question of depreciability. Section 1.167(a)-3 of those Regulations provides that a depreciation deduction may be taken only when an asset "is *known from experience or other factors* to be of use in the business or in the production of income for only a limited period . . . ." 26 C.F.R. § 1.167(a)-3 (1993) (emphasis supplied).

to continue indefinitely." *Ithaca Industries,* 97 T.C. 253 (slip op. at 17-18), 1991 WL 151392. These are elements of value which have always been understood to be non-depreciable, primarily because they do not decline in any readily ascertainable fashion, but also because their initial value is difficult to appraise.

One of the reasons the Tax Court felt that Ithaca's workforce was non-depreciable was because the workforce closely resembled going-concern value. Indeed, "the existence of a trained and operational staff allowed Ithaca to step into the shoes of Old Ithaca." *Id.* This approach, measuring the asset against the definition of going concern value, was supported by then-existing law, *see Houston Chronicle,* 481 F.2d 1240, but has been modified by the Supreme Court's recent holding in *Newark Morning Ledger Co. v. United States,* —— U.S. ——, 113 S.Ct. 1670, 123 L.Ed.2d 288 (1993). That case addressed only goodwill specifically, but its teaching is equally applicable to going-concern value. The Court stated, "we now hold that a taxpayer able to prove that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life *regardless of how much the asset appears to reflect the expectancy of continued patronage. . . .*" *Id.* —— U.S. at ——, 113 S.Ct. at 1681 (emphasis supplied). Thus, it is no longer appropriate to classify an intangible asset based on its resemblance to the classic conception of goodwill or going-concern value, and Ithaca's deduction cannot be denied on that basis.

Newark Morning Ledger does not, however, wholly eliminate a categorial approach to the question whether an asset declines, or "wastes," within the meaning of section 167. The Court left intact the so-called "mass asset" rule, which

> provides that certain kinds of intangible assets are properly grouped and considered as a single entity; even though the individual components of the asset

> may expire or terminate over time, they are replaced by new components, thereby causing only minimal fluctuations and no measurable loss in the value of the whole.

Id. at 1676.[8] A mass asset is thought to be non-wasting, and therefore not depreciable, because it is continually regenerated, such that at any given time, the asset is the same in all material respects as it always has been. This is so even when the asset's constitutive elements change over time.

On its face, then, a workforce that remains constant in size and function over the years would appear to be a quintessential mass asset. As employees leave the workforce, new individuals are hired to assume the responsibilities of each vacant position. These new employees are indeed distinct from the individuals who made up the original workforce, but for all practical purposes the assembled workforce as a whole is preserved.

As the Court suggested in *Newark Morning Ledger*, however, the distinguishing feature of a true mass asset is its ability to be regenerated without substantial effort on the part of its owner, that is, its ability to "self-

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[8] We emphasize, however, that the potential application of the mass asset rule in this case has nothing to do with whether the workforce appears to contribute to going concern value. The Supreme Court has indicated that after *Houston Chronicle*, the rule could no longer serve as authority for classing all assets "related to the expectancy of continued patronage" as inseparable components of the single non-depreciable asset of goodwill. *Newark Morning Ledger*, —— U.S. at ——, 113 S.Ct. at 1677. The reasoning of *Houston Chronicle* would also prohibit application of the mass asset rule to defeat amortization of all assets contributing to the expectancy of uninterrupted business, that is, to going concern value. Thus, along with the classic conception of goodwill and going concern value, *Newark Morning Ledger* subsumes the mass asset rule under a broader inquiry aimed at determining whether the asset can be valued and whether its useful life is limited. *See infra*, note 11 and accompanying text.

regenerate."[9] When an asset is maintained only by significant affirmative efforts to add new elements, these additions are most naturally understood as comprising something new and distinct from the original asset. Conceptually, the "old" asset continues to decline, even as the owner acquires new elements to offset declining productivity in the combination of elements that is the old asset. Though the line of demarcation is subtle, this situation is analytically distinct from one in which the asset is replenished without significant effort; such a "self-regenerating" asset requires little or no active addition of new elements to preserve it against decline. Thus, when an intangible asset such as a workforce is maintained only by obtaining costly replacements, those replacements do not prevent decline in the existing asset so much as they contribute to what might be considered a new one. In such a case, the "mass asset rule" would not defeat amortization of the asset.

The distinction is crucial in this case, for Ithaca's workforce as a whole was indeed regenerated each time a new worker was brought in to fill a vacancy, such that the size and function of the workforce remained essentially the same. This regeneration, however, was accomplished

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[9] The Court's discussion of the District Court's opinion in *Newark Morning Ledger* illustrates the importance of the concept of self-regeneration to the mass asset rule:

> Petitioner also proved to the satisfaction of the District Court that its "paid subscriber" asset [a list of subscribers obtained by one newspaper in its takeover of another] was not self-regenerating, *thereby distinguishing it for purposes of applying the mass-asset rule:*
>
> "[T]here is no automatic replacement for a subscriber who terminates his or her subscription. Although the total number of subscribers may have or has remained relatively constant, . . . those that may or have discontinued their subscriptions can be or have been replaced only through the substantial efforts of [the newspaper]."

Newark Morning Ledger, —— U.S. at ——, 113 S.Ct. at 1681 (emphasis supplied) (citation omitted).

only through Ithaca's substantial efforts. Absent those efforts, the workforce as it was constituted on the date of the merger would have declined until there were no employees left in it. Ithaca did not have replacement workers standing ready to be hired and put to work without significant preparation. On the contrary, the record indicates that Ithaca had to train its workers extensively, and in some cases even had to recruit them.[10] In fact, it is these expenses which form the basis of the value Ithaca has assigned to the workforce. Under these circumstances, the mass-asset rule does not deny Ithaca a depreciation deduction for its workforce.

The inquiry must therefore turn to whether Ithaca's workforce has an ascertainable value and a limited useful life.[11] Because the Tax Court did not feel that a

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[10] Ithaca's recruiting and training expenses may well have been deductible, but the tax treatment of these expenses is irrelevant to the issue of self-regeneration and the application of the mass asset rule. *Cf. Computing & Software, Inc. v. Comm'r*, 64 T.C. 223, 236-37, 1975 WL 3186 (1975) (original body of credit information amortizable despite continual replacement with new information by clerks whose pay was currently deductible). After all, even if a traditionally depreciable, tangible business asset like a truck could be preserved indefinitely with new parts and the labor required to install them, we would not think that the truck was self-regenerating and non-wasting simply because the expenses of this maintenance were deductible. The important question is whether the asset's maintenance is accomplished by significant efforts not already expended in the initial formation or purchase of the asset.

[11] Of course, this broader inquiry addresses many of the same issues with which the mass asset rule is concerned. As the Fifth Circuit noted in *Houston Chronicle*, "[m]ost of the cases purporting to apply the 'mass asset' rule involve evidentiary failures on the part of the taxpayer[,]" namely, a failure to show that the asset has an ascertainable value and a limited useful life. 481 F.2d at 1249-50. Stated another way, if the taxpayer is unable to counter the inference that his asset self-regenerates, and is therefore a mass asset, he has also failed to prove that the useful life of his asset is limited.

regenerating asset such as a workforce could waste, it did not undertake to assess Ithaca's statistical evidence on these questions in any detail. We need not pay detailed attention to Ithaca's statistical methodology, either, but we look beyond this evidence for a different reason. We do not doubt that Ithaca's workforce, as constituted on the day of the merger, began to decline in size and value with the first resignation, termination, or death in that workforce, and that it continued to decline due to these and other factors. Nor do we take issue at this time with the value Ithaca placed on that workforce.[12] The difficulty in our view is that under these circumstances there can be no defensible estimation of the duration of any one person's employment, nor of the useful life of the workforce of which he or she is a part.

In *Newark Morning Ledger,* the taxpayer was a newspaper which sought to amortize the body of subscriptions it obtained from another newspaper in a merger. Despite the fact that new subscriptions were coming in daily to replace lapsed ones, the Court allowed Newark Morning Ledger to depreciate the old subscription list. It did so, however, only because the body of subscriptions as it was constituted on the merger date "was not composed of constantly fluctuating components; rather, it consisted of identifiable subscriptions each of which had a limited useful life that could be estimated with reasonable accuracy according to generally accepted statistical principles." *Newark Morning Ledger,* —— U.S. at ——, 113 S.Ct. at 1681. Though each subscription was terminable at will by the subscriber, there were some

[12] We must note, however, our concern with Ithaca's use of the cost of recruiting and training replacement workers as a proxy for the value of the workforce obtained from Old Ithaca. The two groups of workers may not be sufficiently comparable to allow this approach. *Cf. Newark Morning Ledger,* —— U.S. at ——, 113 S.Ct. at 1682 (citing district court's finding that new newspaper subscribers were not comparable in value to customers on existing subscriber list).

460,000 paid subscribers on the list Newark Morning Ledger obtained. The large sample size enabled the newspaper's experts to employ historical and demographic data on mortality and relocation rates, as well as changing tastes and media competition, to arrive at an estimate of useful life.[13]

Without intimating a view whether Newark Morning News' method would produce an *adequate* estimate, we can say that this case presents a rather different set of circumstances. An employee is not a subscription; indeed, a workforce consisting of human beings perhaps could be no better described than as "composed of constantly fluctuating components." We note in this regard that the record discloses no predetermined limits of any sort, contractual or otherwise, upon the relationship between Ithaca and its employees. This means that in contrast to a subscription, which is susceptible mainly to the influences affecting one actor, the subscriber, a single employment relationship is susceptible to changing influences affecting two actors, the employer and the employee.

We are not persuaded that Ithaca can control for these influences. With a large enough sample size and a test period of sufficient length, it is conceivable that pertinent variables and reliable patterns of attrition could be identified. This, after all, is the purported accomplishment of actuarial compilations used in the insurance industry. And theoretically, similar data might be derived from very small, exceptionally stable environments. But we are far from being able to perform such feats reliably with a sample size of roughly 5,000 different people,

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[13] The Government contested none of this evidence, but chose instead to stand on the assertion that "paid subscribers" are indistinguishable from the concept of goodwill. The adequacy of Newark Morning Ledger's evidence thus was not directly before the Court.

over only a four-year period, and with only four classifications by job type.[14]

Ithaca's representation that its estimate of attrition rate was born out following the merger does not convince us otherwise. An unforeseen change in any pertinent variable might have radically undermined Ithaca's estimate at any time, and the fact that it did not is in this court's judgment little more than happenstance. The revenue consequences are simply too serious to tolerate this level of imprecision, and we cannot now envision an approach to a workforce such as Ithaca's that would not suffer from the same shortcomings as Ithaca's statistical method.[15]

In sum, we hold that Ithaca's workforce was not an amortizable asset because its characteristics suggest no sufficiently accurate means of estimating its useful life. In the absence of a firmer foundation, we must also decline to choose an appropriate useful life convention. If any conventions are to be adopted to end the intract-

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[14] Ithaca's statistical expert, Dr. Doerfler, analyzed Old Ithaca's employment experience from 1979 until the merger date, assessing the average useful lives for workers in four categories: hourly and production workers, executives, salaried employees, and clerical employees.

[15] We are mindful, of course, that in *Citizens & Southern Corp. v. Comm'r*, 91 T.C. 463, 1988 WL 90987 (1988), *aff'd*, 919 F.2d 1492 (11th Cir.1990) (per curiam), the Tax Court approved Dr. Doerfler's useful life analysis, a methodology similar to the one employed here. *Citizens & Southern*, however, dealt with the depreciability of a bank's deposit base. We believe, as we have indicated, that a workforce such as Ithaca's poses a far greater challenge. A workforce is an unusual asset because it is not only affected by human decisionmaking, but is actually *composed* of multiple human actors. As such, it is directly affected by the complex interactions of its employees, and by any number of other influences operating upon these actors both in and out of the workplace. This substantial human element injects vagaries into the useful life analysis that make inapt, on the facts of this case, the analysis used in *Citizens & Southern*.

able struggles over the depreciability of intangible assets such as this, it is the province of Congress to do so.[16] The opinion of the Tax Court is therefore

AFFIRMED.

PHILLIPS, Circuit Judge, concurring in part and dissenting in part:

I agree competely with Judge Michael's excellent legal analysis leading to the conclusions that (1) Ithaca Industries' claimed deduction is not defeated by the mass asset rule, and (2) could only be defeated by a determination that its workforce either had no ascertainable value upon acquisition or no ascertainable limited life thereafter. I disagree however, with the further conclusion that we should decide as a matter of law on this appeal that it had neither.

Those issues should, I believe, be remanded for first instance determination by the Tax Court where they were raised but not decided. I think we jump the gun in deciding (as I read the majority opinion) that as a matter of law *no* statistical methodology (not just that of Ithaca Industries' original proffer) could provide a sufficiently trustworthy evidentiary basis for finding both ascertainable value and limited useful life for this work force. *See* pp. 689-91. I believe instead that the Tax Court as trier-of-fact should originally make that assessment. It might well decide, after carefully considering the proffered evidence, that it had just the inherent in-

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[16] In this vein, Congress adopted section 197 of the Internal Revenue Code in August, 1993. *See supra*, note 6. The avowed purpose of section 197 was to eliminate "the considerable controversy" that has existed between taxpayers and the Internal Revenue Service over whether and how to amortize intangible assets, a controversy which Congress predicted would continue even after *Newark Morning Ledger*. *See* H.R.Rep. No. 103-11, 103rd Cong., 1st Sess. 760 (1993). As counsel for the Commissioner stated at oral argument, however, the new section is merely a convention, meant only to bring "peace."

capacity the majority assigns it. But it might in the context of an appropriate evidentiary hearing find a sufficiency of strength that we are not in too good a position to assess without benefit of any first-instance effort by the base-line trier-of-fact.

For that reason, I would remand those issues for determination by the Tax Court.

APPENDIX B

UNITED STATES TAX COURT

Docket No. 7076-89

ITHACA INDUSTRIES, INC.,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Filed August 12, 1991

SCOTT, *Judge*: Respondent determined deficiencies in petitioner's corporate income tax for its fiscal years ending February 3, 1984, and February 1, 1985, in the amounts of $404,290 and $572,775, respectively. The issues for decision are: (1) Whether an assembled work force is an intangible asset distinct from goodwill or going-concern value with an ascertainable useful life over which the value of the asset may be amortizable; (2) whether raw material supply contracts are assets distinct from goodwill or going-concern value with an ascertainable useful life over which the value of the asset may be amortizable; and (3) if either the work force in place or the raw material contracts has a value apart from goodwill or going-concern value and an ascertainable useful life, what is the useful life and proper value allocable to each such asset? [1]

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code as amended and in effect for the years in issue.

Petitioner in its brief states that "petitioner acquired old Ithaca in a statutory merger that was treated by petitioner as a purchase

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

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of Old Ithaca stock and a liquidation under Internal Revenue Code (Code) section 334(b)(2) as then in effect." Sec. 334 as generally applicable for the years 1983, 1984, and 1985 provides:

SEC. 334. BASIS OF PROPERTY RECEIVED IN LIQUIDATIONS.

(a) GENERAL RULE.—If property is received in a distribution in complete liquidation (other than a distribution to which section 333 applies), and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution.

(b) LIQUIDATION OF SUBSIDIARY.—

(1) DISTRIBUTION IN COMPLETE LIQUIDATION.—If property is received by a corporation in a distribution in a complete liquidation to which section 332(a) applies, the basis of the property in the hands of the distributee shall be the same as it would be in the hands of the transferor.

(2) TRANSFERS TO WHICH SECTION 332(c) APPLIES.—If property is received by a corporation in a transfer to which section 332(c) applies, the basis of the property in the hands of the transferee shall be the same as it would be in the hands of the transferor.

(3) DISTRIBUTEE DEFINED.—For purposes of this subsection, the term "distributee" means only the corporation which meets the 80-percent stock ownership requirements specified in section 332(b).

(c) PROPERTY RECEIVED IN LIQUIDATION UNDER SECTION 333.—If—

(1) property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock, and

(2) with respect to such acquisition—

(A) gain was realized, but

(B) as the result of an election made by the shareholder under section 333, the extent to which gain was recognized was determined under section 333,

then the basis shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any

On the date of filing its petition, petitioner was a Delaware corporation with its principal place of business in Wilkesboro, North Carolina. It timely filed U.S. corporation income tax returns for its fiscal years ending February 3, 1984, and February 1, 1985, with the Internal Revenue Service Center at Memphis, Tennessee. Petitioner keeps its books and files its Federal income tax returns on an accrual basis.

Ithaca Industries, Inc. (Old Ithaca), was formed in 1948 by George Abbott (Mr. Abbott), as a manufacturer of women's intimate apparel. In 1982 Mr. Abbott was the majority stockholder, owning approximately 70 percent of the stock. The other stockholders at that time were Gregory B. Abbott, G. Christopher Abbott, and Nicholas Wehrmann. By 1982 Old Ithaca had become the largest private label manufacturer of women's sheer hosiery and underwear in the United States. It was also a major producer of men's and boys' private label underwear.

Sometime around 1983, Mr. Abbott decided to retire from active involvement in the corporation. At that time, Old Ithaca was a client of Merrill Lynch Capital Markets

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money received by the shareholder, and increased in the amount of gain recognized to him.

The effective date of sec. 334 as set forth above is generally Aug. 31, 1982. However, there are numerous exceptions to the effective date of Aug. 31, 1982, for dissolutions planned prior to Aug. 31, 1982, and for situations where a ruling had been obtained prior to that date.

In any event, respondent has not questioned the fact that petitioner is entitled to allocate the amount paid for the stock of Old Ithaca among the assets of Old Ithaca which it received. The only determination made in the notice of deficiency issued to petitioner in this case is that an assembled work force and certain supply contracts are not assets separate from goodwill or going-concern value to which an amount of the purchase price of the stock may be properly allocated. The facts surrounding the merger are not shown in this record in complete enough form to determine which section of the Code is applicable.

(Merrill Lynch CM). Representatives of Merrill Lynch CM suggested to Mr. Abbott a public offering of Old Ithaca stock in order to provide liquidity to the shareholders, in particular to Mr. Abbott. Because of the length of time required to complete a public offering, the shareholders of Old Ithaca considered other options, including a sale of their entire interest in the corporation.

The Abbott family then discussed with representatives of Merrill Lynch Capital Partners, Inc. (Merrill Lynch CP), the possibility of a leveraged buyout. The representatives of Merrill Lynch CP considered Old Ithaca a very attractive investment due to its stability, management, position in the marketplace, and good relations with customers. The primary purpose of a leveraged buyout would be to provide liquidity to Mr. Abbott with respect to his interest in Old Ithaca.

Petitioner was incorporated by Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch) on September 22, 1983, as New Ithaca Corp. (New Ithaca) for the purpose of acquiring the assets and business of Old Ithaca. New Ithaca offered the shareholders of Old Ithaca $110 million consisting of $5,432,432.43 of junior subordinated notes and the balance in cash, in exchange for all common stock of Old Ithaca. The offering price was determined by Merrill Lynch from industry comparables, preliminary discussions regarding the public offering, imputed values from financial projections, and the need to balance the sales price against the ability to finance the sale. The Abbott family considered the price and concluded that it was attractive to them. The purchase price reflected the fair market value of Old Ithaca.

On October 28, 1983 (day of the merger or merger date), New Ithaca purchased the stock of Old Ithaca and then liquidated Old Ithaca. Following the liquidation, New Ithaca changed its name to Ithaca Industries, Inc. (Ithaca). As of November 11, 1983, after the liquidation of Old Ithaca, the stock of New Ithaca was held by

Merrill Lynch Interfunding, Inc., Venture Lending Associates, L.P., General Electric Pension Trust, Gregory B. Abbott, G. Christopher Abbott, and Nicholas Wehrmann.

On or before October 28, 1983, petitioner did not engage in negotiations with the persons selling Old Ithaca's stock with respect to a specific price for the items purchased and Old Ithaca and petitioner did not allocate a specific price to the items purchased. When purchasing a business, Merrill Lynch generally intends to hold the business as a going concern for a number of years, then sell the business as a going concern.

On the day of the merger, Old Ithaca had 17 manufacturing plants and warehouse facilities in North Carolina, South Carolina, and Georgia, a distribution facility in Arizona, an executive office and sales office in New York City, and sales representatives located in various areas of the United States. It employed a work force of approximately 5,153 hourly production employees and had an assembled staff of other than production emloyees of 212 individuals, consisting of 17 executives, 153 other salaried employees, and 42 hourly office employees.

The business operations of Old Ithaca and Ithaca were identical and there was no interruption of business activity as a result of the sale and liquidation. After the sale and liquidation, the officers and management personnel of Ithaca were the same as those of Old Ithaca, with the exception of Mr. Abbott. The members of the board of directors of Ithaca were different from the members of the board of directors of Old Ithaca.

At the time of the merger, the economy was in a deep recession nationally. Unemployment in North Carolina in February 1983 reached a high of 11.4 percent. As a result of the unemployment trends in North Carolina, there were labor surpluses. Workers in the apparel industry are paid low wages and their educational require-

ments are minimal. Large numbers of the workers in the apparel industry are high school dropouts. Most of the workers, particularly the women, move in and out of the labor force with great frequency.

The hiring process for production workers starts with an application being submitted at one of Ithaca's plants. The application is screened by a designated person within that plant. If the applicant has the necessary qualifications, the applicant is called in for an interview. At the interview, the interviewer goes through the application with the applicant to make sure everything is correct and to see if anything needs to be added. A supervisor or department head then shows the applicant the operation for which he or she is applying. After viewing the operation, the applicant is brought back to the office and a job either will or will not be offered at that time.

The hiring process for a salaried employee also begins with an application being submitted, although the actual interview process is usually longer because generally more than one applicant will be interviewed. The applicant will talk to the supervisor of the position applied for and generally those persons offered employment will have followup interviews scheduled, at which time an offer generally will be made. The hiring process for executives often involves the services of an executive recruiter, travel expenses, and the interviewing of a number of applicants for one position.

During 1983, training was generally necessary for a production worker. Initially, the trainee would be familiarized with break times and lunch times and then taken to the area in which the trainee was going to work. Sometimes the supervisor did all of the training, but more often the training was done by a training operator or a training instructor. The trainer would show the trainee an experienced operator who did the work to be performed in a manner that was consistent with the method Ithaca wished to teach and the rapid pace Ithaca ex-

pected. The trainee would watch the experienced operator for some period of time and then would be introduced to his or her particular job.

The next step would be to give the trainee material scraps on which to sew until the trainee felt comfortable operating the sewing machine. The trainee then would be given garments to sew, generally in the beginning an easy size and an easy style. When the trainee began producing garments, the quality control operator would review and grade the garments and the supervisor would also review the work. As the trainee progressed, less and less time would be spent with the supervisor, training instructor, and quality control operator.

A production worker was considered trained when the worker met and maintained Ithaca's standard productivity for at least 2 or 3 weeks consecutively. Standard productivity levels are established by calculating how many garments each operator must produce in a given period of time for the company to operate at profit after covering overhead costs. In making this determination the cost system for the product and the maximum production capability of an operator are considered. The costs incurred by petitioner in the hiring and training of its work force were deducted as business expenses.

Ithaca entered into contracts with hosiery and other retailers to supply them with a stated quantity of garments over a stated period. In anticipation of meeting these contract requirements, Ithaca entered into long-term contracts to purchase raw materials used in manufacturing the garments. In general, each raw material supply contract is evidenced by a written purchase order and a sales contract. The purchase order is prepared by Ithaca's director of purchasing at or about the time the director reaches a verbal agreement with a supplier regarding the terms of a supply contract. The sales contract is a document containing identical terms to the purchase order. It is generally prepared by the supplier and signed by

both parties. Either party might suggest a change in one or more terms of a supply contract, and the supply contract would be altered if both parties agreed to such alteration. The delivery dates were chosen by Ithaca and were occasionally modified.

The process of negotiating prices of yarn for yarn supply contracts includes obtaining price quotations over the telephone from a variety of suppliers and checking with suppliers who made acceptable quotations as to the availability of the volume of yarn desired by Ithaca. Some of the factors affecting the pricing of both 100-percent cotton and cotton/polyester-blend yarns include the following: Price movement on the common commodity futures market, the delivery dates desired (relative to the available supply of cotton and yarn), the volume to be purchased, supply and demand, and the type and quality of yarn to be purchased. The cotton market is very volatile and the price is influenced by fluctuations in the cotton commodity futures market. The price of synthetic cotton-blend yarn fluctuates with the price of both cotton and polyester. Supplier's yarn prices are competitive. Large yarn customers such as Ithaca, with volume business, have more leverage and can negotiate more favorable prices than smaller customers.

If Ithaca needs an additional supply of the type of yarn covered by a supply contract that has been completed, Ithaca's director of purchasing will enter into a new series of price negotiations with a variety of suppliers. Old Ithaca and Ithaca generally requested and negotiated "far out" delivery dates of 1 year or longer.

Mr. Ed Mohn was director of purchasing of both Old Ithaca and Ithaca. The director of purchasing purchases cotton and cotton/polyester-blend yarns and oversees the timely delivery of the yarns against raw material supply contracts which have been entered into. As a matter of business routine, Mr. Mohn also kept copies of all pur-

chase orders and sales contracts, receiving records, and correspondence relating to such documents.

Inside Textiles is a textiles market newsletter published every 2 weeks. Among other things, the newsletter presents market price ranges for a number of fibers and cotton and cotton/polyester-blend yarns. These ranges are derived from quotations which the editor solicits from a variety of sources in the industry, including sellers and purchasers of yarn. Inside Textiles contains market price ranges for several types of yarn which are covered by Ithaca's raw material supply contracts. The published yarn prices are yarn prices from the preceding 2 weeks.

As of the merger date, petitioner had entered into supply contracts with various suppliers or agents that were in various stages of completion and had delivery dates extending past the merger date. The contracts terminated by their terms on various dates, the latest of which was approximately 14 months after October 28, 1983. None of the raw material contracts, by their express terms, could be assigned without the consent of the supplier. Deliveries of the yarn covered by contract numbers 3743, 7965, 7992, 6591, 6592, 4511, 033176, C889, C1228, 11488-7, 442, 2172 (Jaman yarns), 2172 (Rowann Mills), 9040, 2748, 8495, 8498, and 8496 were not completed on the merger date. These contracts all show a cost per pound for yarn to be delivered over the remaining term of the contract.

Mr. Ed Mohn for petitioner kept in its record some notations of market prices for yarn. The next week's prices shown in Inside Textiles were substantially the same as the notations of market prices kept by Mr. Ed Mohn. Petitioner purchased yarn in such large quantities that it generally obtained its yarn at a lower price than either the market prices shown in Inside Textiles or the market prices shown in its own records kept by Mr. Ed Mohn. On one contract with respect to cotton yarn 18.1, the price obtained by Ithaca was 6 cents per pound less than

the mid-range of the contemporaneous listings quoted by Inside Textiles.

Separate receiving records are maintained by petitioner's personnel with respect to shipments made under each supply contract. These records show the date of each delivery and the supply contract balance left to be delivered after substracting the amount received by Ithaca as of that date. From the receiving records for most of the supply contracts, it is possible to ascertain the remaining balance of a supply contract as of the merger date.

Several months prior to the merger date, the American Appraisal Co. (AAC) appraised the assets of Old Ithaca. The appraisal was used by petitioner to provide a valuation for bank lenders and to determine an allocation of basis for tax purposes. The allocation of basis was as follows:

Allocation	*Amount*
Cash	$ 1,722,000
Accounts receivable	22,138,000
Inventory	39,108,000
Prepaid expense	765,000
Fixed assets	62,722,000
Patents	11,860,000
Raw material contracts	1,760,000
New York office lease	165,000
Work force in place	7,700,000
Deferred debt expense	2,750,000
Goodwill	3,845,000
Other	508,000
Investment in subsidiary	5,092,000
Basis in assets acquired	160,135,000

The amount allocated by petitioner to goodwill was determined under the residual method. Under the residual method, goodwill is equal to the excess of the basis over the aggregate fair market value of the identifiable tangible and intangible assets.

On the basis of AAC's allocation of $7,700,000 to the work force in place, petitioner assigned an average per capita amount to each of its hourly and production work force and staff employees and amortized that amount when that person's employment relationship terminated. Accordingly, petitioner claimed deductions for amortization of assembled staff and work force in the amounts of $674,104 and $1,884,422 for the fiscal years ending February 3, 1984, and February 1, 1985, respectively.

On its returns petitioner allocated a basis to 26 raw material supply contracts in the total amount of $1,760,000, with the value of each contract allocated over the term of the contract. Petitioner amortized the value of each raw material supply contract over its remaining term. Petitioner claimed amortization deductions with respect to the raw material contracts in the amounts of $495,440 and $1,264,560 for the fiscal years ending February 3, 1984, and February 1, 1985, respectively.

In his notice of deficiency, respondent disallowed the deductions claimed for amortization of the work force in place in the amounts of $674,104 and $1,884,422 for the fiscal years ending February 3, 1984, and February 1, 1985, respectively, with the explanation that the amount of purchase price allocated to the work force in place is part of going-concern value and not properly amortizable. Respondent also disallowed the deductions claimed for amortization of raw material contracts in the amounts of $495,440 and $1,264,560 for the fiscal years ending February 3, 1984, and February 1, 1985, respectively, with the explanation that the amount of the purchase price allocated by petitioner to the raw material contracts is part of goodwill or going-concern value and not properly amortizable.

OPINION

Assembled Work Force

Section 167(a) allows as a deduction for depreciation a reasonable allowance for the exhaustion and wear and tear of property used in a trade or business or of property held for the production of income. The term "property" includes intangibles. *Citizens & Southern Corp. v. Commissioner,* 91 T.C. 463, 479 (1988), affd. without published opinion 900 F.2d 266 (11th Cir. 1990). Section 1.167(a)-3, Income Tax Regs., provides that an intangible asset may be amortized if the—

> intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy * * *.

No deduction for depreciation is allowable with respect to goodwill or going-concern value since neither has an ascertainable useful life. Sec. 1.167(a)-3, Income Tax Regs.; *United States v. Cornish,* 348 F.2d 175 (9th Cir. 1965).

To depreciate an intangible asset, a taxpayer must demonstrate that the asset has a limited useful life, the duration of which can be estimated with reasonable accuracy, and an ascertainable value separate and distinct from goodwill or going-concern value. *Southern Bancorporation, Inc. v. Commissioner,* 847 F.2d 131, 136-137 (4th Cir. 1988), affirming a Memorandum Opinion of this Court; *Houston Chronicle Publishing Co. v. United States,* 481 F.2d 1240, 1250 (5th Cir. 1973); *Citizens & Southern Corp. v. Commissioner, supra* at 479.

Petitioner contends that the assembled work force is an asset separate and distinct from goodwill or going-concern value and that this asset has an ascertainable limited useful life. Petitioner concludes that the replace-

ment cost method can be used to value the assembled work force and that when valued on this basis no part of the value of this assembled work force is an integral part of going-concern value. Respondent contends that an assembled work force represents the value inherent in having a trained staff of employees in place enabling the business to continue without interruption, and is going-concern value. Respondent argues that, because going-concern value is not a depreciable asset, petitioner is not entitled to a deduction for amortization of the assembled work force.

Respondent contends that, as a matter of law, the value of an assembled work force represents going-concern value. Petitioner argues that the determination of whether the assembled work force is an intangible asset with an ascertainable useful life and value and, therefore, subject to amortization, is a question of fact. Although it has been consistently held that no deduction for amortization is allowable for goodwill and going-concern value, section 1.167(a)-3, Income Tax Regs.; *United States v. Cornish, supra,* it also has been consistently held that the determination of whether an intangible asset is part of goodwill or going-concern value is a question of fact. *Houston Chronicle Publishing Co. v. United States, supra* at 1245-1251; *Citizens & Southern Corp. v. Commissioner, supra* at 479. Accordingly, whether the assembled work force is an intangible asset with an ascertainable value and a limited useful life separate from goodwill or going-concern value is a question of fact.

Going-concern value is "the additional element of value which attaches to property by reason of its existence as an integral part of a going concern." *VGS Corp. v. Commissioner,* 68 T.C. 563, 591 (1977). It is characterized by the ability of an acquired business to continue to operate and generate income without interruption during and after acquisition. *UFE, Inc. v. Commissioner,*

92 T.C. 1314, 1323 (1989); *Solitron Devices, Inc. v. Commissioner,* 80 T.C. 1, 19-20 (1983), affd. without published opinion 744 F.2d 95 (11th Cir. 1984); *VGS Corp. v. Commissioner, supra* at 592; *Computing & Software, Inc. v. Commissioner,* 64 T.C. 223, 235 (1975). While goodwill and going-concern value are often referred to conjunctively, technically going-concern value is the ability of a business to generate income without interruption, even though there has been a change in ownership; and goodwill is a "preexisting" business relationship, based on a continuous course of dealing, which may be expected to continue indefinitely. *Computing & Software, Inc. v. Commissioner, supra* at 232. See also *Winn-Dixie Montgomery, Inc. v. United States,* 444 F.2d 677, 685 (5th Cir. 1971).

Prior case law supports a conclusion that, because an assembled work force is necessary to allow the business to operate and generate income without interruption during and after acquisition, such assembled work force generally is not an asset that is separate and distinct from going-concern value.

In *First Pennsylvania Banking & Trust Co. v. Commissioner,* 56 T.C. 677, 690 (1971), when discussing the amount of the amortization deduction to which the taxpayer was entitled with respect to a mortgage servicing business it had purchased, we stated:

> We note that the agreement did not (and obviously could not) state that Clarke's employees were bound over to Penn, but this does not detract from the *probability* that the employees would join petitioner's operation and that this factor formed a part of the going-concern value which was purchased. * * *

Under the facts in *First Pennsylvania Banking & Trust Co. v. Commissioner, supra,* when the directors and stock-

holders of W.A. Clarke Mortgage Co. (Clarke), which serviced mortgage loans for various institutions, decided to liquidate and dissolve the corporation, First Pennsylvania Banking & Trust Co. (Penn), became interested in acquiring from Clarke the right to service a major portion of the mortgage loans Clarke was servicing. Penn had no mortgage service department of its own, but it anticipated starting up such a department by employing a large portion of Clarke's staff and acquiring Clarke's furniture and fixtures. In its negotiations with the lending institutions, Penn represented that it expected to employ Clarke's personnel to do the servicing. Subsequently Clarke entered into an agreement of sale with Penn.

The issue before this Court was the amount of the purchase price of Clarke with respect to which Penn was entitled to amortization deductions. Respondent argued that, although Penn was entitled to amortization deduction for the right to receive servicing fees, Penn had also purchased intangible assets from its predecessor such as the right to service future loans and Clarke's goodwill and going-concern value.

Before the transaction, Clarke originated loans for various lenders and also serviced loans which in many cases it had originated. Penn hired most of Clarke's employees, serviced loans formerly serviced by Clarke, serviced future loans of some of Clarke's customers, had full use of the escrow funds associated with all loans, and was in possession of Clarke's records and information on servicing loans. From the outset, Penn knew that it would employ Clarke's personnel and take over the files and equipment, thus benefiting from Clarke's experience and know-how. The personnel were expected to and did continue to perform the same duties and services as they had for Clarke. We found in *First Pennsylvania Banking & Trust Co. v. Commissioner, supra* at 690, that a portion of what was paid for the right to service the existing loans and the right to use the escrow amounts associated

therewith were amortizable and the remaining portion of the purchase price paid was allocable to goodwill or going-concern value, nonamortizable intangible assets.

In *Computing & Software, Inc. v. Commissioner, supra,* Computing & Software, Inc., acquired substantially all the properties, assets, and liabilities of Consumer Credit Clearance and the assets, including the credit information files, goodwill, and trade names, of Retail Merchants Credit Association and of Credit Bureau of Compton and Lynwood. Consumer Credit Clearance, Retail Merchants Credit Association, and Credit Bureau of Compton and Lynwood operated credit information services.

One of the issues before this Court was whether the credit information files were subject to depreciation. We found that the taxpayer had satisfied its burden of proof and established that the credit files purchased were separate and distinct from the goodwill of the companies purchased because the credit information had value for only a limited period. However we found that in addition to credit information files, goodwill and going-concern value had been purchased. In concluding that going-concern had been purchased, we listed factors which demonstrated that the taxpayer could continue to provide services to customers of the acquired business without interruption because of a takeover. These factors included:

> —an organization that was doing business and earning money; a network of customers and the expectation that their patronage would continue; a staff of employees trained in working with the credit files and dealing with the organization's customers; an established routine for supplying available credit information and obtaining and recording new data from various sources; and an established routine for recording the fees charged for credit-reporting services and billing the customers. * * * [*Computing & Software, Inc. v. Commissioner, supra* at 235.]

The portion of the price attributed to the above-listed factors was found to be nondepreciable.

Petitioner's contention with respect to its work force is conceptually similar to that in the cases discussed above. The existence of a trained and operational staff allowed Ithaca to step into the shoes of Old Ithaca. Ithaca acquired an organization that was doing business and earning money, had a staff of employees trained in operating sewing machines, working with fabrics, etc., and had an established routine for preparing garments. While the employees of Old Ithaca were not bound over to Ithaca, this fact does not detract from the probability that the employees would join Ithaca's operation. Therefore, the assembled work force represents going-concern value, which has been regarded as not having an ascertainable useful life.

Generally an asset has been regarded as an asset distinct from goodwill and going-concern value where the evidence shows such asset to be a wasting asset with a reasonably ascertainable useful life and value. An asset is subject to amortization only if it is a wasting asset. *Richard S. Miller & Sons, Inc. v. United States,* 210 Ct. Cl. 431, 537 F.2d 446, 452 (1976). Depreciation is intended to reflect the loss in value of an asset used to produce income and to make a meaningful allocation of the cost to the tax period benefited by the use of the asset. *Massey Motors, Inc. v. United States,* 364 U.S. 92 (1960). The Eighth Circuit Court of Appeals, in discussing the theory of depreciation, stated—

> This allowance for depreciation is intended to provide a nontaxable fund to restore income-producing assets at the end of their useful life and their capacity to produce income has ceased or, to allow a taxpayer to recoup his investment in wasting assets free of income tax. * * * [*Northern Natural Gas Co. v. United States,* 470 F.2d 1107, 1109 (8th Cir. 1973),]

In this case, it is "the assembled work force" that petitioner claims is a wasting asset, not each individual worker. Although the assembled work force is used to produce income, this record fails to show that its value diminishes as a result of the passing of time or through use. As an employee terminated his or her employment, another would be hired and trained to take his or her place. While the assembled work force might be subject to temporary attrition as well as expansion through departure of some employees and the hiring of others, it would not be depleted due to the passage of time or as a result of use. The turnover rate of employees represents merely the ebb and flow of a continuing work force. An employee's leaving does not interrupt or destroy the continued existence of the whole. To the extent the leaving of any employee reduces the value of the assembled work force as a whole this value would be restored by the hiring of a new employee. The whole of the assembled work force is equal to the sum of its employees but each employee enjoys no separate capital standing independent of the whole. See generally *Golden State Towel & Linen Service, Ltd. v. United States,* 179 Ct. Cl. 300 (1967); *Thrifticheck Service Corp. v. Commissioner,* 33 T.C. 1038, 1047 (1960), affd. 287 F.2d 1 (2d Cir. 1961). Because the assembled work force does not diminish in value as a result of the passage of time or through use, there is no loss in value that must be allocated to the tax period benefited by the use of the assembled work force.

The cases relied on by petitioner, such as *Citizens & Southern Corp. v. Commissioner,* 91 T.C. 463, 479 (1988), affd. without published opinion 900 F.2d 266 (11th Cir. 1990), *Houston Chronicle Publishing Co. v. United States,* 481 F.2d 1240 (5th Cir. 1973), and *First Pennsylvania Banking & Trust Co. v. Commissioner,* 56 T.C. 677 (1971), where the addition of new deposit accounts or customers or service contracts obtained by the taxpayer were held not to replace the ones purchased by

the taxpayer which were lost through the years, are factually distinguishable from the present case. The assets involved in those cases are very different from an assembled work force. In the situations involved in those cases the taxpayer would attempt to obtain as many new customers, contracts, or deposit accounts as possible since those accounts would mean growth of the business. If new accounts had to be used in replacing an account taken over from another concern that had been lost, this growth might not occur, but the obtaining of new accounts, customers, or contracts was in no way limited to replacing ones taken over from a predecessor which were lost. Here, absent a growth in the petitioner's business or change in that business which was not shown to have occurred, petitioner's work force was stationary and replacements were made only when there was a person who resigned, retired, or was fired. Therefore, the replacement did replace the person lost rather than being an addition or increase. Except when losing a worker, petitioner would not hire a new worker. Therefore the work force as such did not diminish as did a group of deposit accounts, service contracts, or subscriber lists. The work force continued with only necessary replacements. The necessary replacements did not form a separate asset of petitioner as did the subscribers, service contracts, or bank deposit accounts obtained by a taxpayer through its own efforts. The obtaining of new subscribers, customers, contracts, or deposit accounts might well represent growth of the taxpayer's business rather than replacing a diminishing asset. We conclude from the facts here present that petitioner's assembled work force was not a wasting asset.

If the asset is not a wasting asset, the taxpayer must wait until he sells the business to recover any gain or loss inhering in that asset. *Misegades v. Commissioner,* 53 T.C. 477 (1969). In *Misegades* the taxpayer purchased a patent law practice. We held that it was customary for retiring patent attorneys and the estate of a deceased

patent attorney to sell the patent law practice. In finding that the taxpayer had purchased an intangible asset in the nature of goodwill which had no ascertainable useful life, we stated that—

> at whatever time petitioner retired, or should he continue in practice until his death, at the time of his death the intangible asset composed of the patent law practice which he purchased might have a value equal to or in excess of the amount petitioner paid for the asset. Therefore, there is nothing in this record to indicate that an amortization or depreciation deduction should be allowed with respect to the $45,000 over petitioner's life expectancy. * * * [*Misegades v. Commissioner, supra* at 486.]

The assembled work force, just as the patent law practice involved in *Misegades,* is not a wasting asset. The assembled work force would be included in any sale of the entire business by petitioner as it was in petitioner's purchase of the assets of Old Ithaca and at the time of such a sale petitioner would realize any gain or loss with respect to the assembled work force.

Petitioner argues that it has shown that there is a limited useful life of the assembled work force separate and distinct from going-concern value and, therefore, has shown that it is an asset separate from goodwill or going-concern value. A taxpayer may establish the useful life of an asset for purposes of depreciation based on his own experience with similar property or, if his own experience is inadequate, based on the general experience of the industry. Sec. 1.167(a)-1(b), Income Tax Regs. Mathematical or absolute accuracy is not required when estimating the life of a depreciable asset. A rough estimate or reasonable approximation is sufficient. *Burnet v. Niagara Falls Brewing Co.*, 282 U.S. 648, 654-655 (1931); *Super Food Services, Inc. v. United States,* 416 F.2d 1236, 1238 (7th Cir. 1969); *Citizens & Southern Corp.*

v. Commissioner, 91 T.C. 463, 500 (1988), affd. without published opinion 900 F.2d 266 (11th Cir. 1990). The useful life must be based on facts existing as of the close of the taxable year in issue. *Southern Bancorporation, Inc. v. Commissioner,* 847 F.2d 131, 137 (4th Cir. 1988), affirming a Memorandum Opinion of this Court; *Citizens & Southern Corp. v. Commissioner, supra* at 500. Evidence of a taxpayer's subsequent experience is acceptable to corroborate its projections based on prior experience. *Citizens & Southern Corp. v. Commissioner, supra* at 500.

Petitioner argues, first, that the life of the work force is limited because employees will terminate their employment with petitioner. The termination will be either voluntary, involuntary, or as a result of death. Petitioner argues that the fact that the employment relationship will terminate at the latest upon the death of the employee establishes a limited useful life for the assembled work force under the holding of *Newark Morning Ledger Co. v. United States,* 734 F. Supp. 176 (D.N.J. 1990).

In *Newark Morning Ledger Co. v. United States, supra,* a predecessor to Newark Morning Ledger Co., Herald Co., purchased all the outstanding stock of paid-circulation newspapers. A paid-circulation newspaper is one where the newspaper is sold to the readers. Herald Co. claimed depreciation deductions for the paid-circulation subscribers of the newspapers that it acquired. The issue before the court was whether the acquisition of existing paying subscribers was an amortizable intangible asset separate and apart from goodwill.

The facts in *Newark Morning Ledger Co. v. United States, supra* at 176, are distinguishable from the facts in the present case since it is the work force in place that petitioner contends is the separate asset in the instant case. This fact distinguishes this case from *Newark Morning Ledger Co. v. United States, supra,* as it does from the

other cases relied on by petitioner in valuing customers or subscribers. In the case of accounts, customers, or subscriptions, the new account, customer, or subscriber obtained is not necessarily related to the discontinuing of the old and the taxpayer would prefer to keep both. In the instant case only when an employee leaves is he or she replaced so that there is no change nor is there intended to be a change in the assembled work force. The training of the new employee to keep the assembled work force unchanged is a deductible expense.

Petitioner contends that our holding in *Citizens & Southern Corp. v. Commissioner, supra,* supports its argument that the assembled work force has a limited useful life. The taxpayer in *Citizens & Southern Corp. v. Commissioner, supra,* acquired nine banks and allocated a portion of the purchase price to an identified deposit base as a separately defined intangible asset. The deposit base had a value equal to the present value of the future stream of income to be derived from employing the purchased core deposits of a bank. The taxpayer proved that the deposit base had an ascertainable cost basis separate and distinct from the goodwill and going-concern value of the acquired banks and that it had a limited useful life, the duration of which could be ascertained with reasonable accuracy. We held that the taxpayer was entitled to allocate to the deposit base an amount equal to the present value of the difference in cost between the acquired core deposits and the market alternative.

The facts in this case are distinguishable from *Citizens & Southern Corp. v. Commissioner, supra.* In *Citizens & Southern* this Court made a factual determination that the core deposits at issue did not possess any characteristics of goodwill. On the facts in this case, we conclude that the assembled work force is not an asset that is separate and distinct from going-concern value since it is not a wasting asset.

Petitioner relies on the analysis of a Dr. Doerfler, whom it engaged to conduct a lifing analysis of the assembled work force in place on the date of the merger to support its argument that the assembled work force has a limited useful life which can be measured with reasonable accuracy. Specifically, Dr. Doerfler was engaged to determine the rate at which workers employed by Ithaca on the date of the merger could be expected to terminate employment following the acquisition. Dr. Doerfler determined that the average useful life of the aggregate assembled work force was approximately 6.8 years and summarized how 5,149 employees would be expected to terminate over the subsequent years. Respondent objects to the statistical method used by Dr. Doerfler. However, we need not decide whether this statistical method is appropriate since we do not agree that such statistical method is an accurate measure of the useful life of the assembled work force. Dr. Doerfler has attempted to determine the useful life of the individuals who make up the work force on the day of the merger, not the length of time the work force as an assembled entity will exist in the hands of the corporation. As noted above, each employee is not a separate asset independent of the whole as would be the situation under petitioner's theory. The rate at which the individual employees who make up the work force on a specific day will leave their jobs is not a determination of the length of time an assembled work force as an entity will be an intangible asset of the business. This is evidenced by the fact that, while individual employees that make up the assembled work force on a specific date may leave the work force at a predictable rate, the work force as an assembled entity does not diminish by reason of the employees leaving. If the useful life of the employees employed on the date of the merger were the same as the useful life of the assembled work force, at the end of 6.8 years petitioner would no longer have an assembled work force. Clearly, this is not the case.

Accordingly, we hold that the assembled work force is not separate and distinct from going-concern value and, because it is not a depreciable asset, that amortization deductions claimed by petitioner are not allowable.

Raw Material Contracts

Under section 167(a) and section 1.167(a)-3, Income Tax Regs., a contract which has a limited life and is utilized in the business of a taxpayer may be amortized ratably over its useful life. *Triangle Publications, Inc. v. Commissioner,* 54 T.C. 138, 147 (1970). In order to show that a contract is amortizable, a taxpayer must establish that the contract has a limited useful life, the duration of which can be estimated with reasonable accuracy, and an ascertainable value separate and distinct from goodwill and going-concern value. *Southern Bancorporation, Inc. v. Commissioner,* 847 F.2d 131, 136-137 (4th Cir. 1988), affirming a Memorandum Opinion of this Court; *Houston Chronicle Publishing Co. v. United States,* 481 F.2d 1240, 1250 (5th Cir. 1973); *Citizens & Southern Corp. v. Commissioner,* 91 T.C. at 479.

Petitioner argues that the contracts are separate and distinct from going-concern value. Respondent argues that the favorableness of the contracts does not constitute an asset that is separate and distinct from going-concern value because a supply of yarn is essential for the business operations of Ithaca to continue without interruption. Respondent contends that the contracts represent favorable business factors and as such are part of going-concern value.

Respondent states that *VGS Corp. v. Commissioner,* 68 T.C. 563 (1977), supports his contention. In *VGS Corp.* a predecessor of VGS Corp. acquired all of the stock of another corporation and certain assets of a partnership. No allocation of the purchase price was made to supply contracts held by one of the acquired companies. No allocation was made to the contracts because

no competitive advantage was gained from them, not because they were considered to be part of going-concern value. We conclude that our holding in *VGS Corp. v. Commissioner, supra,* does not support respondent's contention.

We do not agree with respondent that the fact that a supply of yarn is essential for petitioner's business operations requires the characterization of the yarn contracts asset as goodwill or going-concern value. Certain equipment may be essential for business operations, but the equipment may also be a depreciable asset, separate and distinct from going-concern value. While raw materal is necessary to enable Ithaca to continue its business, contracts for acquisition of the raw material at a specified price are assets that are separate and distinct from going-concern value. See *Triangle Publications, Inc. v. Commissioner,* 54 T.C. 138 (1970); *Hoffman v. Commissioner,* 48 T.C. 176 (1967).

Petitioner argues that the contracts had a useful life of 14 months. Respondent argues that the contracts did not have a limited useful life. While the useful life of an asset must be based on the facts as they exist at the close of the taxable year in issue, *Southern Bancorporation, Inc. v. Commissioner, supra*; *Citizens & Southern Corp. v. Commissioner,* 91 T.C. 463, 500 (1988), affd. without published opinion 900 F.2d 266 (11th Cir. 1990), a taxpayer may establish the useful life of an asset based on its own experience with similar property. Sec. 1.167(a)-1 (b), Income Tax Regs.

Respondent argues that the life of the contracts is indefinite because any value inhering in the contracts exists only so long as the favorable price spread is predicted to exist. Respondent argues that because yarn prices fluctuate, it is impossible to predict with any accuracy the length of time the spread would exist. We find this argument unpersuasive. The favorable spread of the contracts is not the asset being amortized. The

asset is the contracts themselves. The favorable spread is used only to determine the value of the contracts.

Respondent argues that the contracts are indefinite in length because the existing contracts would be replaced with new contracts with the same suppliers and therefore were regenerative. Where a contract is renewable indefinitely as a matter of course it generally will be considered as having an indefinite life and therefore not subject to amortization under section 167. *Triangle Publications, Inc. v. Commissioner,* 54 T.C. 138, 147 (1970). The probability of future renewals is a question of fact. *Toledo TV Cable Co. v. Commissioner,* 55 T.C. 1107, 1117 (1971), affd. 483 F.2d 1398 (9th Cir. 1973); *Westinghouse Broadcasting Co. v. Commissioner,* 36 T.C. 912, 921 (1961), affd. 309 F.2d 279 (3d Cir. 1962). The contracts here in issue were not renewable as a matter of course. The cotton and polyester markets were very volatile. While new contracts might or might not be negotiated by petitioner with the same supplier, neither the purchaser nor the supplier would be willing to enter into a contract that was automatically renewable or consider any contract as automatically renewable with prices as volatile as those of the yarn market. The record here supports petitioner's contention that the yarn contracts were not automatically renewed. Petitioner presented convincing evidence that all contracts were entered into only after negotiations. Each contract would contain its own quantity to be delivered, delivery schedule, type and quality of yarn, and price. The price that could be obtained would depend on the amount Ithaca intended to order, the supply and demand of the market in general, the time of year Ithaca was placing its order, the time between placing the order and delivery, and sometimes the price of polyester. Each contract here involved is separate and distinct from a predecessor contract even when the parties are the same. The fact that old contracts which are not by their terms renewable may be replaced with new contracts does not make the life of the old con-

tracts indefinite or regenerative. See *Commissioner v. Seaboard Finance Co.*, 367 F.2d 646 (9th Cir. 1966), affg. a Memorandum Opinion of this Court.

Respondent next argues that the contracts are indefinite in length because the stated delivery or termination dates were occasionally changed. Because of the volume of yarn that Ithaca purchased and the length of time from order to delivery the parties contemplated a reasonable measure of flexibility in the delivery schedule of the yarn. This is evidenced by the fact that it was common for the delivery dates to be altered. However since alteration was by mutual agreement of the parties, the provisions of the contracts were honored by both parties. The fact that the delivery schedule was altered to meet the needs of Ithaca and that final delivery was not always completed before the termination date stated on the contract does not cause the contracts to have an indefinite life. Petitioner need only establish a reasonable approximation of the useful life of an asset for purposes of depreciation. *Burnet v. Niagara Falls Brewing Co.*, 282 U.S. 648, 655 (1931). We find that a 14-month useful life for the yarn contracts as a whole is a reasonable approximation. Accordingly, we hold that the yarn contracts are an intangible asset properly amortizable over a 14-month period.

Respondent argues that the nonassignment clause in each contract destroys any favorableness because the seller would consent to an assignment only if the contracts were favorable to the supplier on the acquisition date. Generally in a merger the surviving corporation succeeds to the rights of the old corporation by operation of law, not by assignment. Therefore, the nonassignability clause in the contract would not have prevented petitioner from enforcing its rights under the supply contracts following the merger. See *Econo-Travel Motor Hotel Corp. v. Taylor*, 301 N.C. 200, 271 S.E. 2d 54 (1980). The nonassignment clause in the contracts would of course

have an effect on petitioner's ability to sell them, which would mean that the value of these contracts could not be reasonably determined on a sale basis. However, the nonassignment clause does not keep the contracts from having a value to petitioner. The contracts enable petitioner to obtain yarn at a price less than current market price. The nonassignment clause without the seller's consent affects the value of the contracts, but does not cause them to have no reasonably ascertainable value.

Petitioner measured the savings yielded by each supply contract by computing the difference between the price in the supply contract and the claimed market price for the same yarn as of the merger date. The savings were then computed for the remaining term of each supply contract by multiplying the favorable price differential by the pounds to be delivered in each month. The present value of the total savings per month was determined using an 11.99-percent discount rate. Those savings were then tax-effected at a rate of 48 percent and the amortization benefit factored in.

Respondent, through his expert witness Mr. Kim, computed the value of the contracts (as an alternative to claiming that no value could reasonably be computed) by using a lesser market price and a 15-percent discount rate and eliminating contracts which showed no deliveries after the merger date or that had been completed prior to the merger date. Petitioner in appendix III to its brief followed respondent's system except that petitioner used the same market price for yarn that had been used in its prior compilations. On the basis of this compilation, which petitioner stated was the "value of raw material contracts using Mr. Kim's formula," petitioner arrived at a fair market value of the contracts of $951,353. After reviewing all of the evidence in this case and considering the opinions as to the value of the yarn contracts as of the date of the merger given by both petitioner's and respondent's expert witnesses, we conclude that the most reason-

able method of valuing these contracts is the method as used in appendix III to petitioner's brief with the exception that the market price used by petitioner in the compilation is too high. Petitioner's compilation makes no adjustment for the fact that petitioner as a quantity purchaser was able to obtain a better price than the going market price used in the compilation. Neither the price from petitioner's own records nor the market prices from Inside Textiles adjusts for quantity purchases.

The testimony of respondent's witness shows with respect to at least one contract that the price obtained on the date of the merger or substantially close to that date by petitioner in a purchase of yarn was 6 cents per pound lower than the mean quoted market price of Inside Textiles and petitioner's own recorded market price. We conclude that some discount must be taken on the market price used by petitioner in making the compilation in order to determine the true value of the yarn contracts considering prices petitioner would have paid without the contracts. The current market prices used by petitioner for the various yarns ranged from a low of $1.73 to a high of $3.17. From the record in this case, we cannot determine a precise average price either on all cotton yarns or yarns with some polyester. However, we conclude based on the record as a whole that a reasonable discount on all the prices for the quantities in which petitioner purchased is 2.5 percent on the market price at the date of merger as used in appendix III attached to petitioner's brief. If in any instance this results in a market price below the contract price, that particular contract should be eliminated since from the testimony as a whole it appears to be unlikely that there were prices at the merger date in October 1983 that were lower than the contract prices for the same yarn. We, therefore, decide that a proper computation of the market value is the value as computed in appendix III to petitioner's brief after adjusting market prices as used in that compilation

by reducing such prices by 2.5 percent but eliminating any contracts where no savings result. The parties can make the computation of the value of the yarn contracts determined on this basis in connection with their recomputation under Rule 155.

Decision will be entered under Rule 155.

APPENDIX C

Filed March 22, 1994

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 92-1045
89-7076

ITHACA INDUSTRIES, INC.,
Petitioner-Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee

ON PETITION FOR REHEARING WITH
SUGGESTION FOR REHEARING IN BANC

Appellant filed a petition for rehearing with suggestion for rehearing in banc.

Judge Phillips voted to grant panel rehearing. Judge Wilkinson and Judge James H. Michael, Jr., sitting by designation, voted to deny. No member of the Court requested a poll on the suggestion for rehearing in banc.

The Court denies the petition for rehearing with suggestion for rehearing in banc.

Entered at the direction of Judge Wilkinson for the Court.

For the Court,

/s/ Bert M. Montague
Clerk

APPENDIX D

STATUTE

§ 167. Depreciation

(a) General rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

In the case of recovery property (within the meaning of section 168), the deduction allowable under section 168 shall be deemed to constitute the reasonable allowance provided by this section, except with respect to that portion of the basis of such property to which subsection (k) applies.

REGULATION

§ 1.167(a)-3 Intangibles.

If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill. For rules with respect to organizational expenditures, see section 248 and the regulations thereunder. For rules with respect to trademark and trade name expenditures, see section 177 and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960]